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Rep. Pat Ingraham
P.O. Box 1151
Thompson Falls, MT 59873

EXHIBIT

DATE

1-19-09

HB

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Dear Rep. Ingraham,

You have asked about the implications of House Bill No. 824, introduced during the 2007 legislative session, in light of federal case law on the taxation of pension income. The bill as introduced would have exempted all military retirement income from taxation. The \$3,600 exemption of other retirement income would not have been affected. The House Taxation Committee amended the bill to exempt the first \$15,000 of military retirement income. The House of Representatives approved the measure on second reading, but the bill was rereferred to the House Appropriations Committee where it was tabled.

On March 28, 1989, the U.S. Supreme Court held invalid in Davis v. Michigan Department of Treasury, 489 U.S. 803, 103 L. Ed. 2d 891, 109 S. Ct. 1500 (1989), a Michigan income tax law that provided a full exemption from state taxation of state and local government pensions but provided only a partial exemption from state taxation of federal pensions. The Court ruled that the Michigan law violated 4 U.S.C. 111, that allows the state taxation of

... pay or compensation for personal services as an officer or employee of the United States ... if the taxation does not discriminate against the officer or employee because of the source of the pay or compensation.

The State of Michigan argued that section 111 applied only to current employees of the federal government. The U.S. Supreme Court concluded that retirement benefits are compensation for services rendered "as an officer or employee of the United States".

The Court also rejected Michigan's assertion that there was a rational basis in exempting state retirement income as an inducement for hiring and retaining qualified employees. The state also argued that the discriminatory tax treatment of federal retirees was justified because federal retirement benefits were, on average, more generous than state benefits. The Court said that even if the assertion were correct, that

... [a] tax exemption truly intended to account for differences in retirement benefits would not discriminate on the basis of the source of those benefits ... rather, it would discriminate on the basis of the amount of benefits received by individual retirees.

The Michigan law violated the principle of intergovernmental tax immunity and was therefore illegal under the Supremacy Clause of the U.S. Constitution. The ruling meant that retirement

benefits received by federal retirees may not be taxed in a manner less favorable than for state and local retirees. The Court noted that the appropriate remedy to achieve equal treatment in the taxation of public retirement benefits belonged to the state.¹

Prior to Davis, Kansas had allowed a full exclusion for state and federal retirement benefits but provided a \$120 tax credit for military retirees. Despite Davis, the Kansas Supreme Court upheld the state's tax treatment of military retirees. The state Court concluded that military pensions were different from ordinary pension benefits paid to state and local retirees. The Court reasoned that because military retirees may be recalled to active duty, their pensions represent "current pay" for reduced services. In Barker v. Kansas, 503 U.S. 594 (1992), the U.S. Supreme Court rejected the Kansas Supreme Court's reasoning, concluding that there was no significant difference between state retirees and military retirees; that is, military retirement benefits are determined in a manner very similar to state and local retirement benefits.

Federal law and the two court decisions discussed above prevent states from treating federal and military retirement income less favorably than state and local retirement income. For your information, I am enclosing a recent report from the National Conference of State Legislatures that summarizes current state laws regarding the taxation of retirement income, including the taxation of Social Security income. Although state policies vary considerably, many states apply the same tax rules to all sources of retirement income (private pension income may be treated less favorably than public retirement income). You will also notice that many states exempt Social Security income while taxing retirement income to some extent.

A few states tax military retirement income differently from federal retirement income. Connecticut taxes all retirement income, but beginning in tax year 2008, the state will provide a 50 percent exclusion of military retirement income. New Jersey and Wisconsin exclude all military retirement income; Wisconsin does not exclude other retirement income from taxation (see note on Wisconsin in the NCSL report). West Virginia excludes all state and local pensions for public safety retirees (and certain retired federal law enforcement retirees), but caps the exclusion of all other retirement income at \$2,000. The exclusion amount for military retirement income is \$22,000. The West Virginia Court of Appeals upheld the preferential treatment of public safety retirees because it applied only to a limited number of public retirees (Brown v. Mierke, 191 W. Va. 120, 443 S.E. 2d 462 (1994), cert. denied, 513 U.S. 877 (1994)). The U.S. Supreme Court declined to review the case (cert. denied).

In response to a question regarding whether there are any legal barriers to exempting only military retirement income from taxation while taxing other types of retirement income, an analyst at the Connecticut Office of Legislative Research concluded that the court cases (Davis

¹Twenty-four states, including Montana, were directly affected by Davis. These states responded in a variety of ways to the decision. For example, Alabama, Kentucky, and Michigan exempted all public pension income; Alabama extended the exclusion to private retirement income. Arizona, Arkansas, Montana, and North Carolina reduced the amount of the exclusion for state and local retirees to the level previously allowed for federal retirees. Iowa, New Mexico, and Oregon eliminated the preferential treatment of retirement income but did provide other tax benefits to people 65 years of age or older.

and Barker) do not prevent states from providing more favorable tax treatment of military retirement income and that "[t]here appears to be no legal impediment to a state treating military retirement income more favorably than other pensions for income tax purposes."² Although not a legal opinion, that conclusion makes sense because the preferential tax treatment of military retirement income should not involve intergovernmental tax immunity.

Article II, section 35, of the Montana Constitution states: "The people declare that Montana servicemen, servicewomen, and veterans may be given special considerations determined by the legislature." For example, 15-30-116, MCA, exempts from individual income taxation the salary received from the armed forces by residents of Montana who are serving on active duty in the regular armed forces and who entered into active duty from Montana. Section 15-6-211, MCA, provides a property tax exemption to certain disabled veterans. Providing more favorable tax treatment of military retirement income, as contained in House Bill No. 824, would be consistent with the Montana Constitution and should not be inconsistent with federal law.

I hope that this response answers your question. If you need more information, please contact me.

Yours truly,



Jeff Martin
Research Analyst

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²Judith Lohman, Chief Analyst, "Military Pension Exemption From State Income Tax", OLR Research Report, 2005-R-0185, Connecticut Office of Legislative Research, February 16, 2005, available from <http://www.cga.ct.gov/2005/rpt/2005-R-0185.htm>; accessed November 6, 2007, p. 3.